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SUBJECT: CROATIA 2008 INVESTMENT CLIMATE STATEMENT (PART II)

REF: STATE 158802

This is Part II of Croatia's 2008 Investment Climate Statement. The numbering of paragraphs continues from Part I.

A.8 Transparency of the Regulatory System

¶42. Croatia is under pressure to increase transparency and its commitments to adopt EU laws, norms, and practices, provide steady pressure for reform. Nevertheless, bureaucracy and regulation continue to be overly-complex and time-consuming.

¶43. In 2006, the Croatian government, with the assistance of USAID, began the Hitrorez project, which has as its goal the elimination of thousands of laws and regulations that affect business in Croatia. The goal of the project is remove needlessly complex bureaucracy as an obstacle to investment. At the end of its first phase in mid-2007, Hitrorez identified 599 regulations for simplification or elimination. As of September 2007, 123 Hitrorez recommendations had been implemented, with plans to implement another 158 recommendations by February 2008.

¶44. New legislation on public procurement, accounting and financial security was passed in 2007 with the intent to increase transparency. An amended Company Law is expected in April 2008. The new procurement law provides for greater transparency with the introduction of electronic auctions, definitions of special procurement procedures and framework agreements, as well as publication of all procurement procedures over 70,000 HRK ($14,000). The new Accounting Law includes reporting provisions according to which large companies will apply International Financial Reporting Standards, while small and medium businesses will apply Croatian Financial Reporting Standards. Progress, however, is still necessary in this area.

¶45. Bureaucracy is still a major challenge for foreign investors, although the government has made progress in this area, particularly through the development of its e-government initiatives (see paragraph 34). Property registration, for example, has traditionally been notoriously inefficient, sometimes taking up to several years. However, recent reforms and the digitization of the land registers are hopeful signs that this problem will be mitigated in the near future (see paragraph 34). A valuable source of analysis is located on the website of the Croatian office of the World Bank, at www.worldbank.hr. Click on the link for the "Doing Business in Croatia Forum."

¶46. The regulatory system does not specifically discriminate against foreign investors. However, transparency in developing legislation and regulation is often hampered by an inefficient public administration, a lack of intra-governmental coordination, and reliance on expert advice from national champions, sometimes giving

the latter a privileged position in influencing new regulations.

¶47. Tax on corporate income is a flat 20%. There is a 15% tax on interest revenue and royalties. In 2005, tax on dividends was eliminated as a spur to investment. For a detailed description of extant tax legislation, please consult the Tax Administration's website at www.pu.mfin.hr/en. Detailed information about customs can be found at www.carina.hr.

¶48. The Institute of Public Finance maintains a useful table of Croatian taxes at www.ijf.hr/eng/taxguide/08_05/taxtable.pdf, and the Ministry of Finance maintains information at www.pu.mfin.hr/en. Croatia also maintains a 22 percent value-added tax (VAT). Some companies have had difficulty with the tax authorities due to differing understandings of how certain goods and services are affected by the VAT.

A.9 Efficient Capital Markets and Portfolio Investments

¶49. Croatia's markets are open to both domestic and foreign investment equally. There are no restrictions that would disrupt foreign investment in the securities market and other markets in Croatia. Foreign residents may open non-resident accounts and may do business both domestically and abroad. Article 24 of the Foreign Currency act states that non-residents may subscribe, pay in, purchase or sell securities in the Republic of Croatia in accordance with regulations governing securities transactions. Non-residents and residents are afforded the same treatment in spending and borrowing. These and other non-resident financial activities regarding securities are covered by Articles 24, 25 and 27 of the Foreign Currency Act, which can be viewed on the Central Bank website (www.hnb.hr).

¶50. Croatia's capital markets grew strongly in 2007. The ZSE saw

record trading in 2007, which nearly doubled to 22 billion HRK ($4.4 billion) from 2006. According to the Central Depository Agency records, approximately 840,000 Croatian citizens now own stocks.

¶51. In 2006, the amended Investment Fund Law went into force, which provides for the establishment of derivative funds, index funds and other funds in accordance with EU legislation.

¶52. The Agency for Supervision of Financial Services (HANFA), headed by the Directorate for Supervision of Agencies oversees the capital market in Croatia. See www.hanfa.hr for all legislation and information relative to capital markets.

¶53. The privatized and consolidated banking sector is advanced and is becoming more competitive. More than 90% of the total assets of the banking sector are foreign owned. By the 2nd quarter of 2007, there were 33 commercial banks and five savings banks, whose assets totaled 325.2 billion HRK ($65 billion). Austrian-owned Zagrebacka Bank (23.05%) and Privredna Bank (17.26%) are the two largest banks per percentage of total bank assets in Croatia.

¶54. The government uses the market to finance government expenditure. Government debt instruments must be bought through an intermediary such as a commercial bank, and are tradable on exchanges.

¶55. Currently, securities are traded on the Zagreb Stock Exchange (ZSE), established in 1991. The Varazdin Stock Exchange (VSE), which was established in 1993 as an over-the-counter (OTC) merged into the ZSE in 2007. The OMX X-Stream trading system is now used on the ZSE.

¶56. The Securities Law requires that all companies with more than 100 shareholders and with share capital of at least HRK 30 million (approximately $5.4 million) list on the newly established quotation for public stock companies (JDD). The intention was to increase transparency and encourage companies to obtain low cost equity financing, which would result in increased turnover and trade volumes.

¶57. All Croatian workers under age 40 are required to pay five percent of their gross salary into a pension fund of their choice. EU Pillar III (additional voluntary savings with government matching of 25%) has also been introduced. Croatian financial markets are benefiting from this infusion of capital.

¶58. Transactions on the Zagreb Stock Exchange in 2007 were 66.49 billion HRK (approximately $13.34 billion), of which 39.05 billion HRK (approximately $7.83 billion) was in institutional turnover. In 2006, transactions totaled 49.06 billion HRK (approximately $8.79 billion) of which 29.39billion HRK (approximately $5.27billion) was institutional turnover

¶59. There are three tiers of securities traded on the ZSE. Companies must meet high disclosure and operating requirements to be fully listed (quotation I). A detailed explanation of all requirements is provided at www.zse.hr in English.

¶60. The Croatian Chamber of Economy provides a useful summary of the capital markets in Croatia at: www.hgk.hr.

A.10 Political Violence

¶61. The risk of political violence in Croatia is low. Following the break up of Yugoslavia and the subsequent wars in the region, Croatia has emerged as a stable, democratic country on the threshold of NATO membership. Membership in the European Union is also likely in the coming years. Relations with neighboring countries are generally good and improving, although some disagreements regarding border demarcation remain.

¶62. There is little domestic anti-American sentiment. There have been no incidents involving politically motivated damage to American projects and/or installations in Croatia.

A.11.a Corruption

¶63. Corruption remains a problem in Croatia. The EU highlighted corruption as a major challenge in its November 2007 progress report on Croatia's accession negotiations and citizens continue to cite corruption as one of the most important problems plaguing their society.

¶64. Croatia has ratified the Council of Europe Criminal Law Convention on Corruption, the Council of Europe Civil Law Convention

on Corruption, the United Nations Convention Against Transnational Organized Crime and the United Nations Convention Against Corruption.

¶65. Croatia is also a member of GRECO (the Group of States Against Corruption), a peer monitoring organization that allows members to assess anticorruption efforts on a continuing basis. An evaluation of Croatia including suggestions and opinions on Croatia's progress in its fight against corruption, can be found on GRECO's website (www.greco.coe.int).

¶66. The Office for the Prevention of Corruption and Organized Crime (USKOK, which is the agency responsible for battling corruption, is currently staffed by 36 employees and participates in joint task forces with the Ministry of Finance and Police. In June 2007, USKOK was the lead in the largest anticorruption action to date. Seven persons employed by the Croatian Privatization Fund were arrested on allegations that they accepted bribes and sold state-owned companies without legal bids. The investigation into the case was still underway at year's end. In December 2007, another USKOK operation, this time in the Zagreb land registry, led to charges of bribery and corruption against 26 suspects. The investigation is on-going. There were other cases of alleged corruption involving city officials and businessmen, but none have yet resulted in conviction.

A.11.b Bilateral Investment Agreements

¶67. Croatia does not have a foreign investment law; foreigners receive national treatment under existing legislation. In addition, investments by American citizens are covered by the U.S. Croatian Bilateral Investment Treaty (BIT), which entered into force in June ¶2001. The treaty fulfills the principal U.S. objectives for agreements of this type:

-- All forms of U.S. investment in the territory of Croatia are covered;

-- Covered investments receive the better of national treatment or most-favored-nation (MFN) treatment, both while they are being established and thereafter, subject to certain specified exceptions;

-- Specified performance requirements may not be imposed upon or enforced against covered investments;

-- Expropriation is permitted only in accordance with customary international law standards;

-- Parties are obligated to permit the transfer, in a freely usable currency, of all funds related to a covered investment, subject to exceptions for specified purposes;

-- Investment disputes with the host government may be brought by investors, or by their covered investments, to binding international arbitration as an alternative to domestic courts.

¶68. For further information about BITs and for the text of the U.S.-Croatian BIT please see www.mac.doc.gov/Tcc/e-guides/eg_bits (under "Croatia").

¶69. Croatia has signed investment protection treaties/agreements with the following countries, however, not all have entered into force:

Albania, Argentina, Austria, Belgium, Belarus**, Bulgaria, Bosnia and Herzegovina, Czech Republic, Chile, Denmark, Egypt, Finland, France, Greece, Germany, India, Indonesia**, Iran, Italy, Israel, Jordan, Kuwait, Cambodia, Canada, Qatar*, China*, Cuba**, Latvia, Libya, Hungary, Macedonia, Malaysia*, Malta, Republic of Moldova**, Netherlands, Oman**, Poland, Portugal, Romania, Russia*, United States, Serbia Montenegro, Slovakia, Slovenia**, Spain, Sweden, Switzerland*, Thailand*, Turkey, United Kingdom, Ukraine, Zimbabwe*.
(* = ratified, but not in force) (** = not ratified or in force)

A.11.c OPIC and Other Investment Insurance Programs

¶70. Croatia is eligible for coverage from the U.S. Overseas Private Investment Corporation (OPIC). For more information on OPIC's insurance activities, see www.opic.gov. The OPIC-supported $200 million Bedminster Investment Capital Management Fund invested in the Croatian banking sector (as part of the consortium that purchased Dubrovacka Banka) and the Croatian communications sector (by investing in Digital City Media, a broadband cable TV network in

Croatia). Bedminster Capital Management also manages an OPIC-supported private equity fund -- Southeast Europe Private Equity II -- which targets investments in Croatia, among other countries. Croatia is a member country of the Multilateral Investment Guarantee Agency (MIGA), for more information see www.miga.org. In 2004, OPIC provided $250 million in political risk insurance to support financing for the construction of a motorway in Croatia that will do much to improve the country's infrastructure, reduce transportation costs, and develop the tourism potential of the Dalmatian coast. OPIC provided the insurance to Private Export Funding Corporation (PEFCO) to support PEFCO's financing to Croation Motorways Ltd. for construction of a portion of the Zagreb-Split Motorway, consisting of a tolled four-lane highway connecting

Bregana and Zagreb, and Bosiljevo with Sveti Rok.

¶71. In the event that OPIC should pay an inconvertibility claim under its political risk coverage, the local currency accepted by OPIC in any subsequent recovery would be made available to the Embassy on a priority basis for U.S. Government expenses. The estimated annual U.S. dollar value of local currency used by the Embassy is approximately $16 million. The Embassy currently purchases local currency from a local commercial bank at the market rate. A major devaluation is considered unlikely.

A.11.d Labor

¶72. Croatia has an educated, highly-skilled, and relatively high cost labor force compared with the region. In general, employer's wage costs are approximately 110% of an employee's net wage. The estimated average cost to employers in Croatia was 7,096 HRK (approximately $1,419) per month as of October 2007. The average net wage at the end of the third quarter of 2007 was 4,579 HRK ($915). Minimum wage, as determined by the government, is 2100 HRK gross ($420) monthly, net is between 1400-1500 HRK ($280-$300) depending upon exemptions. The Croatian government controls wage levels in government agencies/institutions and in the remaining state-owned enterprises, affecting around half of all workers. The wages in privately owned companies are freely determined by contracts between employer and employee.

¶73. Croatia adopted new labor laws in mid-2003 aimed at increasing labor market flexibility by shortening the mandatory notification period before dismissal and reducing generous severance package requirements. However, Croatia still fares badly in terms of time and expense in hiring and firing employees. Labor has generally been supportive of government efforts to boost competitiveness and welcomes foreign investment, but remains concerned about any possible cuts in social spending.

¶74. The Law on Labor regulates employee and employer relations through "employment contracts." Fulltime employment must not amount to more than 40 hours per week and employees are entitled to at least 18 working days of paid annual leave and seven days of personal leave. The Law on Labor also provides special protections for workers in dangerous occupations, work at night, and work by minors between the ages of 15 and 18.

¶75. Chapter 7 of the Law on Foreigners covers the issuance of work permits. While there are quotas (determined annually) for work permits, there are no quotas for foreigners who execute key positions in companies or representative offices. Likewise, there are no quotas for business visas.

¶76. Workers are entitled by law to form or join unions of their own choosing, and workers exercised this right in practice. In general, unions were independent of the government and political parties. The Labor Code prohibits anti-union discrimination and expressly allows unions to challenge firings in court; however, in general, attempts to seek redress through the legal system were seriously hampered by the inefficiency of the court system.

A.11.e Foreign Trade Zones/Free Ports

¶77. Croatia has several Free Trade Zones (FTZs), some in war-affected areas. Special incentives are offered to users of FTZs.

¶78. The Law on Free Trade Zones allows a foreign-owned or domestic company in FTZs to engage in manufacturing, wholesale but not retail trade, foreign trade, banking and other financial activities. The Law on Profit Tax also covers business in FTZs. FTZ users are eligible for tariff waivers on imported products. FTZ users who construct or participate in construction of infrastructure projects worth 1 million HRK (about $178,000) or more in the zone, are exempted from paying corporate tax during the first five years of

operation in the zone. Other users in the zone pay corporate tax in the amount of 50% of the regular rate (i.e., 10% instead of 20%).

¶79. FTZs are exempted from any Croatian emergency measures or other restrictions pertaining to foreign trade or hard currency transactions. Users of the zones may freely store their goods and production equipment in the zones. Goods that are not intended for trade on the Croatian market or for domestic consumption are fully exempt from custom duties or taxes. Imported goods will be taxed and assessed duties per the value of the production materials imported for the product and not per the value of the finished product.

¶80. The following fifteen counties currently have FTZS: Buje, Krapina-Zagorje, Osijek, Rijeka, Slavonski Brod, Split, Splitsko-Dalmatinska County, Obrovac, Ploce, Pula, Kukuljanovo, Varazdin, Zagreb, Vukovar, and Ribnik counties. As mentioned previously, EU accession will force the Government to make changes in the free trade zone system and the incentives system associated with them.

A.11.f Foreign Direct Investment Statistics

¶81. Compared to other advanced transitional economies in the region, Croatia is in the middle group in terms of foreign direct investment (FDI). New or green-field investments have seen particularly slow growth. According to the Trade and Investment Promotion Agency, there were 2 large-scale foreign investment projects initiated this year, Rockwool and Applied Ceramics (see list below paragraph 85). Privatization of strategic government-owned assets has been the main source of FDI since Croatian independence. Large state assets such as utilities, the state insurance company and banks, are being sold by the government, usually through international tenders, and in some cases, through initial public offerings (IPOs), as was the case recently with the state oil company INA and the national telecom HT. The Croatian Privatization Fund, the agency responsible for the sale of other assets, has shares and stock in 1112 (mostly non-performing) companies. The state's share of the equity base value of these companies is about 21.8 billion HRK ($4.36 billion). Information regarding the Croatian Privatization Fund, including information on companies currently for sale, can be found on its website, www.hfp.hr.

¶82. In October 2007, the Croatian government, as part of its privatization efforts, offered to the public first rights for purchase of its 32,5 per cent stake in Croatia Telecom (Germany's Deutsche Telekom is the majority shareholder), of which 25 per cent were reserved as priority for Croatian citizens. Individual purchase was limited to 16.695,00 HRK ($ 3,227.20) and included the offer of one free share for every ten retained for at least a year. 358.406 citizens participated in this offer and purchased shares at the cost of 265,00 HRK ($70.56) each.

¶83. Foreign Direct Investment between 1993 and the third quarter of 2007 totaled $24.3 billion, with investments in the financial, chemical and telecommunications sector accounting for 58% of total investment. Croatian firms invested $3.9 billion abroad between 1993 and the third quarter of 2007. FDI in Croatia has shown steady growth in recent years. It is estimated that FDI for the first 3 quarters of 2007 amounted to 9.7% of GDP. FDI per capita is estimated at $1700.

¶84. According to official statistics from the Croatian National Bank, Austria is the largest source of foreign investment in Croatia, accounting for 27% of total FDI since 1993. The Netherlands is second with 17% of total FDI, followed by Germany with 14% and France with 8%. Because transactions are often executed through third countries and the Croatian National Bank records country of origin of the final transaction leading to the investment, in many cases, this results misleading statistics. The U.S. Embassy Zagreb estimates that the actual amount of U.S. investment in Croatia is approximately $ 2.5 billion, making the U.S. one of the leading investors. The leading destinations for total Croatian investment, from 1993 to third quarter 2007, were Serbia and Bosnia Hercegovina with 18% each, the Netherlands with 16% and Hungary with 14%. In the first three quarters of 2007,

Croatians invested $300 million abroad. Hungary was the lead destination for 2007 accounting for 40% of investment, with 30% in the Netherlands, and 7 % each in Serbia and Bosnia Hercegovina.

¶85. The Croatian National Bank provides information about foreign investments in aggregate form which can be found on their website at www.hnb.hr. The following is a list of some of the major ($20 million and above) foreign investments in Croatia to date:

Foreign investor: Barr Pharmaceuticals (U.S)
Pharmaceuticals
Croatian company: Pliva
Value $2.3 billion

Foreign investor: Deutsche Telekom (Germany)
Telecommunications
Croatian Company: Croatian Telecom (51% of shares)
Value: $1.272 billion

Foreign investor: MOL (Hungary)
Oil Industry
Croatian Company: INA d.d. (26% of shares)
Value: $505 million

Foreign investor: Lactalis (France)
Dairy
Croatian company: Dukat
Value $400 million

Foreign investor: Banca Commerciale Italiana (Italy)
Banking/financial services
Privredna Banka (66.66% of shares in 1999 plus 10% in 2002)
Value: $300 million + approximately $50 million, according to media reports

Foreign investor: Unicredito Italiano (Italy)
TAKEN OVER BY BANK AUSTRIA IN 2007
Banking/financial services
Zagrebacka Banka (96% ownership)
Value: $230 million (estimate)

Foreign investor: Erste und Steiermarkische Bank (Austria)
Banking/financial services
Rijecka Banka (85% share)
Value: $155 million

Foreign investor: Austria Creditanstalt Group (HVB Group) (Austria)
TAKEN OVER BY SOCIETE GENERAL IN 2006
Banking/financial services
Splitska Banka (88% ownership)
Value: $132 million

Foreign investor: Heineken N.V. (Netherlands)
Brewery
Karlovacka Pivovara company (94.42%)
Value: $125 million

Foreign investor: Rockwool Group (Denmark)
Stone wool producers
Value $110 million

Foreign investor: Sutivan Investment and Excelsa Anstalt (Lichtenstein)
Hotels and tourism
Plava Laguna (81.5%)
Value: $70 million

Foreign investor: CMC (U.S / Switzerland)
Steel
Croatian company: Sisak Steel Company
Value $52 million

Foreign investor: Ericsson (Sweden)
Telecommunications
Tesla Company
$48 million

Foreign investor: Hofmann and Pankl Betelligungasse (Austria)
Minerals processing
Straza Company
$39 million

Foreign investor: Societe Suisse de Cemment Portland (Switzerland)
Cement
Tvornica Cementa Koromacno company
$38 million

Foreign investor: Applied Ceramics (U.S)
Ceramics
Value $30 million

Foreign investor: Interbrew (Belgium)
Brewery
Zagrebacka Pivovara company

$27 million

Foreign investor: Coca Cola Amatil (Australia)
Non-alcoholic beverages
Croatian company: n/a
$20 million

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